Introduction

Robert Klyman  
Gibson Dunn, Business Restructuring and Reorganization Practice Group Co-Chair

Joel M. Cohen  
Gibson Dunn, White Collar Defense and Investigations Practice Group Co-Chair
Agenda

1. Market Trends
   Allie Schwartz, Cornerstone Research

2. Valuation During Times of Market Uncertainty
   Professor Stuart Gilson, Harvard Business School

3. Fiduciary Duty Considerations
   Robert Klyman, Gibson Dunn

4. Criminal Risks
   Joel M. Cohen, Gibson Dunn
Risk of Bankruptcy and Financial Distress to Private Equity Firms

• The number and value of PE-sponsored buyout deals have increased steadily since the financial crisis.

• LBO purchase price multiples were at an all-time high in 2019 (as compared to before and after the financial crisis).

• Approximately 27% of bankruptcies were filed by PE-backed firms in 2019, compared with about 10% in 2015.

Monthly Count and Total Assets of Companies Filing for Bankruptcy 1/1/16–5/31/20

Source: BankruptcyData
Note: Includes only Chapter 7 and Chapter 11 filings by public companies and private companies with at least $50M in assets or liabilities. For companies where exact assets are not known, the lower bound of the estimated range is used. For 2016–2019, monthly averages for each year are shown.
Industries Under Pressure

Chapter 7 and 11 Bankruptcy Counts
Selected Industries: 2/1/20–5/31/20

Distress Ratios
Selected Industries: 5/29/20

Source: BankruptcyData
Note: Bankruptcy counts include all public companies and all private companies with assets or liabilities > $50 million in their bankruptcy petitions.

Source: S&P Global
Note: The distress ratio is defined as the proportion of loans with bid prices below 80.
Additional Bankruptcies May Be Coming

- According to the Bankruptcy & COVID-19 working group, a surge of bankruptcies may be coming:
  - Analysts are projecting debt default rates of around 20% over the next 18 months, meaning that $500B of debt could end up in bankruptcy.
  - Bank of America warned that another $200 billion of investment-grade debt could be downgraded to junk.
  - The working group raises the possibility of the legal system being overstressed unless it is expanded to handle more cases.
Valuation During Times of Market Uncertainty

Stuart C. Gilson, Ph.D.

Harvard Business School Professor of Business Administration
Current Economic Conditions Expand Scope for Valuation Disputes

• Heightened uncertainty about future cash flows presents challenges for valuation.
  ß As of the end of May 2020, more than one-third of companies in the S&P 500 index withdrew financial guidance.
  ß Analyst disagreement over earnings forecasts is approaching the level previously seen during the height of the financial crisis.
  ß Academic literature has shown that when analyst disagreement is greater, valuation disputes among creditors during bankruptcy are more likely.

• Are discount rates based on historical data applicable during the current environment?
• Are pre-COVID-19 transaction prices comparable given the change in the economic environment?

Disclaimer: Materials in this presentation are intended to be for illustrative purposes only as to topics that may possibly arise in various circumstances. They do not reflect predictions of any nature. They also should not be interpreted as opinions about what types of analyses are more appropriate than others, as such a determination will depend on the specific facts and circumstances that are at issue.
One-Year Forward EPS Estimates

**S&P 500**
1/1/18-5/29/20

**Airlines**
1/1/18-5/29/20

**Hotels, Restaurants & Leisure**
1/1/18-5/29/20

**Specialty Retail**
1/1/18-5/29/20

---

**Source:** Refinitiv

**Note:** EPS estimates are calculated for the next 12 months based on analysts' fiscal year forecasts. Median and Low–High ranges represent the market capitalization-weighted average of the corresponding values across the respective industry constituents.
One-Year Forward EPS Estimates (Cont’d)

**Oil, Gas & Consumable Fuels**
1/1/18-5/29/20

**Pharmaceuticals**
1/1/18-5/29/20

**Technology Hardware, Storage & Peripherals**
1/1/18-5/29/20

**Biotechnology**
1/1/18-5/29/20

Source: Refinitiv
Note: EPS estimates are calculated for the next 12 months based on analysts' fiscal year forecasts. Median and Low–High ranges represent the market capitalization-weighted average of the corresponding values across the respective industry constituents.
Selected S&P 500 Industry Indices
Five-Year Beta Estimates
6/1/19 to 6/1/20

Source: Refinitiv
Note: For each industry, the five-year beta estimate is calculated as the market capitalization-weighted average of the corresponding five-year beta estimated using monthly returns for the individual index constituents. The five-year betas of the individual index constituents are directly from Refinitiv. The following tickers were excluded due to incomplete data: AGN and APA.
Selected S&P 500 Industry Indices
Two-Year Beta Estimates
6/1/19 to 6/1/20

Source: Refinitiv

Note: For each industry, the two-year beta estimate is calculated as the market capitalization-weighted average of the corresponding two-year beta estimated using weekly returns for the individual index constituents. The two-year betas of the individual index constituents are directly from Refinitiv. The following tickers were excluded due to incomplete data: AGN and APA.
Valuation Disputes in Getting to a Chapter 11 Plan of Reorganization

• Enterprise value determines creditor recoveries under a Chapter 11 plan of reorganization.
  ß Senior and junior creditors may disagree over the value of the debtor’s business.
• For companies to reorganize in Chapter 11, creditors must receive a higher recovery value than they would if the debtor were liquidated.
  ß Stakeholders may disagree over the decision to liquidate vs. reorganize the business.
• Disputes over the value of specific assets or the overall business may also arise in connection with other aspects of a bankruptcy proceeding.
  ß Gaining court approval for 363 asset sales or DIP financing.
Example: Exide Technologies

- Exide filed for bankruptcy following acquisitions that increased its debt to over $2.5 billion.
- Debtor sought to cram down on unsecured creditors, who disputed the debtor’s enterprise valuation.
- Experts opined on valuation issues.
Exide Technologies: Valuation Methods

- Valuation experts for the debtor and junior creditors used the same three valuation methods:
  - Comparable Company Multiples
  - Comparable Transaction Multiples
  - Discounted Cash Flows (DCF)
Exide Technologies: Comparable Multiples

• Even in more stable market conditions, experts on Exide disagreed strongly on appropriate multiples:
  ß Multiples of 5.0–6.0 vs. 7.7 for comparable companies
  ß Multiples of 5.5–6.0 vs. 7.0 for comparable transactions
• These differences in multiples alone implied differences in valuations of roughly $200 million to $400 million.
• Current market conditions create heightened challenges for valuation based on multiples:
  ß If forward-looking multiples are used, they depend on forecasts, which are more uncertain in this environment.
  ß Identifying comparable transactions may be challenging given the current unique circumstances.
Exide Technologies: Discounted Cash Flows

• A significant portion of DCF value usually comes from terminal value, particularly for companies in distress.
• Experts need to be aware of the implications of their approach in calculating terminal value and ensure that assumptions are economically consistent.
• Given the current economic environment, estimates are likely to be more uncertain and require additional validation.

![Diagram showing terminal value over years]

- Exit from Chapter 11
- Terminal Value
- Years
- $
Valuation Disputes in Fraudulent Conveyance Litigation

• Companies filing for bankruptcy may face fraudulent conveyance claims over buyouts or other transactions that took place before the onset of COVID-19. Capital structures that involved relatively high leverage can be scrutinized and potentially challenged in court.

• Buyouts, debt issuances, and other major transactions that take place after the onset of COVID-19 may face fraudulent conveyance claims if the company later files for bankruptcy.

• Solvency analyses are often conducted in the context of fraudulent conveyance claims. Three-part solvency test (balance sheet, cash flows test, capital adequacy).
Fiduciary Duties During Insolvency

Robert Klyman
Gibson Dunn, Business Restructuring and Reorganization Practice Group Co-Chair
Overview

• Directors of a financially stressed company may be asked to approve certain transactions, financings, payments or restructuring strategies that could be attacked (with the benefit of 20/20 hindsight) if the company were subsequently to falter or if stakeholders perceive that they were harmed by the transaction or restructuring or perceive a strategic advantage to asserting such claims.

• When a company is financially distressed, the fiduciary duties of its directors may expand to include stakeholders other than the company and its stockholders, such as lenders and other creditors.

• The environment in which directors of a financially stressed company operate has become much more difficult. Courts, regulatory agencies, lenders, bondholders and other stakeholders have become more aggressive and willing to second-guess directors’ decisions.
Topics Covered

• This presentation provides an overview of the duties of corporate directors. Topics include:
  ß Fiduciary Duties;
  ß Standards of Review of Board and Management Decisions;* and
  ß Implications of Financial Distress on Controlling Shareholders.
• This presentation will outline strategies that directors and controlling/major shareholders may take to minimize liabilities in analyzing and approving transactions, financings, payments or restructuring alternatives presented to them.

* We attach as Appendix I an overview of the legal standards for determining solvency.
Fiduciary Duties

• The business affairs of a company are to be managed by its officers under the direction of the board of directors.

• The law of the state of organization of the company determines the scope and extent of management’s and the board’s fiduciary duties.*

* This presentation focuses on Delaware and New York law.
Fiduciary Duties in a Solvent Company Context

<table>
<thead>
<tr>
<th>Stockholders</th>
<th>Creditors</th>
</tr>
</thead>
<tbody>
<tr>
<td>• General Rule: Directors of a solvent company owe their fiduciary duties to the company and derivatively to its stockholders.</td>
<td>• Creditor Rights Are Contractual: Creditors are afforded protection through contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, general commercial law, and other sources of creditor rights.</td>
</tr>
<tr>
<td>• Stockholders have no contractual protections. Accordingly, they are entitled to a high degree of protection from mismanagement as a matter of law.</td>
<td></td>
</tr>
</tbody>
</table>
Fiduciary Duties in an Insolvent Company

• At all times, directors owe a fiduciary duty to the entire “corporate enterprise” or the “community of interests that [sustain] the corporation.”

β When a company is insolvent, however, the community grows to include creditors.

β Case law has clarified that directors do not owe direct fiduciary duties to creditors in an insolvent context. Rather, as with its stockholders, all duties to creditors are derivative: They flow through the directors’ duties to the company.

• When It Is Unclear if the Company Is Solvent:

β Often it is prudent for directors to assume when making decisions that in hindsight a court might find the company was insolvent.

β Directors should act in a manner that preserves and maximizes the value of the company.
The Duty of Care

• Duty of Care
  ß The actions and conduct of directors must be informed and considered, and decisions must be made, with “requisite care.”
  ß Directors are entitled to rely in good faith on reports prepared by officers of the company or outside experts.
• To establish that a board has acted with requisite care, it is important to create and follow a decision-making process and maintain good records to demonstrate that the board’s decision was informed after consideration of all relevant factors associated with the ultimate decision made.
The Duty of Loyalty

• Duty of Loyalty
  ß Directors must act in good faith and in the best interests of the company.
    – As discussed, in an insolvency context, the company can be construed broadly to include the entire corporate enterprise, including creditors.

ß Traditionally, this has applied to self-dealing and corporation usurpation transactions.
  – The duty of loyalty is implicated where a director is not disinterested, e.g., (a) appears on both sides of the transaction, (b) receives a benefit from the transaction that is not received by stockholders generally, or (c) is beholden to a party involved in the proposed transaction such that the director is unable to exercise independent business judgment.
  – Even where some directors are “interested,” the protections of the business judgment rule can be preserved if a special committee of disinterested members of the board separately approves the transaction.
  – However, to the extent the transaction is not so approved, a stricter “entire fairness” standard (discussed below) will be applied to evaluate the transaction.
The Duty of Loyalty (Cont’d)

- Case law has expanded the duty of loyalty beyond self-dealing and corporate usurpation to include a failure to act in good faith, which incorporates a duty of oversight.

- The duty of oversight includes a duty to monitor the company’s operations.

- Under Caremark, a board breaches its duty of loyalty if either (i) the directors completely fail to implement any reporting or information system or controls, or (ii) having implemented such a system or controls, the directors consciously fail to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.

- Duty of oversight has also been implicated where directors (i) fail to place corporate assets up for sale prior to a liquidity crisis; (ii) fail to hire a restructuring advisor in a timely manner; and/or (iii) abdicated all responsibility to the restructuring advisor when one is hired.
The Duty of Loyalty (Cont’d)

• Board members affiliated with the controlling shareholders may be seen as acting at the direction of those shareholders, which could lead to questions of conflict or interestedness (i.e., putting the interests of the sponsor ahead of the stakeholders).

Ъ Case law suggests that where a director designee breaches the duty of loyalty at the direction of the controlling shareholder(s), the controlling shareholder(s) may be financially liable.

Ъ In insolvency, creditors are derivatively able to pursue these claims not only against members of the board but also against controlling shareholders.
Standards of Review of a Board’s Decision-Making

(1) The Business Judgment Rule

- The business judgment rule creates a legal presumption whereby courts are deferential to a decision of the board, even if the decision was ultimately unprofitable or a mistake in hindsight.
- Directors are presumed to have acted in good faith and in the best interests of the company.
- Directors must fulfill the duties of care and loyalty to receive the protection of this presumption.
- The following acts, for example, could result in the loss of this presumption:
  - conflicts of interests;
  - failure to exercise proper oversight;
  - preferential treatment of certain creditors and other stakeholders (including insiders);
  - failure of a director to disclose material aspects of a transaction; and
  - acting without requisite information or deliberation (i.e., breach of the duty of care).
Standards of Review of a Board’s Decision-Making

(2) Entire Fairness

• The “Entire Fairness” standard applies where a board may be conflicted. It often arises in interested director transactions.

β For a distressed company, it typically is prudent for the directors to put in place a process to defend all actions under the entire fairness standard.

β The standard consists of two inquiries: (a) fair price and (b) fair dealing.

– Fair price means a price that a reasonable seller, under all of the circumstances, would regard as within a range of fair value.

– Fair dealing considers both the process that the board followed and the quality of the result achieved.
Additional Factors Criticized By Courts

- In evaluating breach of fiduciary duty claims, the following are factors that courts have mentioned in criticizing the actions of a fiduciary (typically a director of a corporation):
  - acting too quickly
  - passive or sole reliance on outside advisors or management
  - utilizing advisors that are not independent and disinterested
  - failure to negotiate aggressively
  - failure to understand key documents or fundamental aspects of a transaction
  - failure to review reasonably available information
  - failure to ask questions
  - failure to consider reasonable alternatives
  - failure to understand the scope of the assignment
  - failure to take into account different factual circumstances (i.e., one size does not fit all)
  - failure to document key decisions
  - falling victim to a controlled mindset and allowing a controlling party to dictate alternatives or terms
Considerations – No Duty to Liquidate or Continue Operating

• Assuming that decisions are made on an informed, good-faith, disinterested basis, directors are not liable for decisions they make and actions they take in an effort to prolong the corporation’s viability, even in the face of bankruptcy. In re Midway Games, 428 B.R. 303, 315 (Bankr. D. Del. 2010).

However, decisions not made on an informed, good-faith, disinterested basis may include damages for deepening insolvency.

• Delaware law gives protection against challenges to a board’s decision on when/whether to file for bankruptcy if the board’s decision was informed, in good faith, and disinterested.
Alternative Entity Considerations

• Delaware law allows LLCs and LPs to include a waiver of fiduciary duties in the operating or partnership agreement (but it cannot waive the implied contractual covenant of good faith and fair dealing) (6 Del. Code § 17-1101(d)–(f), § 18-1101(c)–(e)).

  In Burtch v. Opus, LLC (In re Opus E., LLC), 528 B.R. 30, 67–70 (Bankr. D. Del. 2015), aff’d, 698 F. App’x 711 (3d Cir. 2017), the court recognized that waivers in an LLC Agreement can limit a bankruptcy trustee’s ability to sue derivatively for breach of fiduciary duty.

• Delaware law also prevents creditors from derivatively asserting fiduciary duty claims as to LLCs and LPs (6 Del. Code § 17-1002, § 18-1002).

  In CML V LLC v. Bax, 28 A.3d 1037 (Del. 2011), the Delaware Supreme Court held that creditors of an insolvent Delaware limited liability company do not have standing under Delaware law to sue derivatively for breach of fiduciary duty. According to the court, § 18-1002 of Delaware’s LLC Act limits standing to pursue such claims to members or assignees of the LLC’s interests in the LLC. Creditors do not qualify as either a member or an assignee.
Strategies to Minimize Risk of Director Liability

• Key Steps to Avoiding Director Liability in Decision-Making:
  ß Avoid interested director transaction issues and the application of the Entire Fairness standard
    - Form a subcommittee of independent directors to review and approve transactions or restructuring alternatives where there is a potential conflict of interest between equity holders and creditors;
  ß Analyze the company’s financial condition before and after the proposed transaction or restructuring;
  ß Retain restructuring advisors and counsel to analyze proposed transactions and associated risks;
  ß Document any decisions made, including any supporting advice; and
  ß Take actions designed to maximize value of the enterprise, rather than the interests of a particular stakeholder.
Strategies to Minimize Risk of Director Liability (Cont’d)

• Directors should evaluate and consider a distressed company’s alternatives with the following question in mind:
  ß “Assuming the company is now insolvent, what is the best course of action that will maximize value?”
  ß “Given our relationship with our equity investors and lenders, would our decision-making process be subject to challenge?”
  ß Caution: A “home run” strategy that would benefit stockholders if successful, but which imposes significant risk of loss to other stakeholders if not successful, is an action that requires careful scrutiny.
Fiduciary Duties: The Corporate Opportunity Doctrine
(Particular Issue for Sponsors)

• Arises from duty of loyalty.

• Corporate Opportunity Doctrine: Directors and officers, as insiders, cannot use their strategic position for their own or their affiliate’s advantage to the exclusion or detriment of the corporation they represent.

• Delaware courts have held that the rule is also applicable in determining whether a controlling shareholder has preempted an opportunity that rightfully belongs to the corporation.

- A “corporate opportunity” exists when a proposed activity, in which the corporation has the ability to engage, is related to the corporation’s present or prospective business.

- But note Alternative Entity Considerations above – i.e., may be reduced or eliminated if provided for in LLC/LP agreements.
Fiduciary Duties: The Corporate Opportunity Doctrine (Cont’d)

• The determination of whether a controlling shareholder or corporate fiduciary has usurped a corporate opportunity that rightfully belongs to the corporation is a fact-intensive inquiry that turns on a number of elements:
  ∞ (1) Whether the corporation is financially able to undertake the opportunity
  ∞ (2) Whether the opportunity is in the corporation’s line of business
  ∞ (3) Whether the corporation has an interest or reasonable expectancy in the opportunity
  ∞ (4) Whether, in taking advantage of the opportunity, the self-interest of the corporate fiduciary will come into conflict with the interests of the corporation
Fiduciary Duties: The Corporate Opportunity Doctrine (Cont’d)

• In re Primedia, Inc. Shareholders Litigation, 67 A.3d 455 (Del. Ch. 2013)
  - Company implemented exchange program, using common stock to repurchase preferred stock at a discount.
  - KKR, which held majority stake in the company and had appointed several board members, also purchased company preferred stock in the secondary market.
  - Plaintiff sued KKR for, among other things, usurping corporate opportunity by purchasing preferred stock.
  - Court dismissed claim, in part, because (i) KKR disclosed opportunity to the company, (ii) the company did not have the resources to purchase the stock with cash, and (iii) the company directors signed a written consent stating that the opportunity would not be in the best interest of the company and waived the opportunity.
Fiduciary Duties: The Corporate Opportunity Doctrine (Cont’d)

• Avoid Corporate Opportunity Liability
  ß Waiver
    – In Delaware, a corporation can renounce its interest in certain types of corporate opportunities by providing so in its certificate of incorporation or through action of its board of directors (see § 122(17) of the Delaware General Corporation Law).
    – Joint-venture members can also waive their expectations to corporate opportunities in the joint venture agreement.
    – Alternative entity documents (limited partnership agreements/limited liability company agreements) can waive obligations altogether.
  ß Disclose opportunity to corporation where necessary.
  ß Establish record in support of corporation’s decision to decline opportunity.
  ß Conflicted directors should abstain.
Fiduciary Duties: Special Fiduciary Duty Issues for Sponsor Employees on Portfolio Company Board

• Sponsor representatives serving as directors of portfolio companies have two sets of constituents to which fiduciary duties are owed:
  β (1) Fiduciary duties that the representative owes to the sponsor.
  β (2) Fiduciary duties owed to the portfolio company and its equity holders.

• To avoid conflicts of interest, a sponsor representative should be mindful of blurring the line between these two sets of potentially diverging obligations.
Fiduciary Duties: Special Fiduciary Duty Issues for Sponsor Employees on Portfolio Company Board (Cont’d)

• Conflicts of interest between the duties owed to the sponsor and the duties owed to the portfolio companies can manifest in several ways:
  - Preferred versus common equity
  - Acquisition decisions
  - Exit decisions
  - Executive compensation
  - Management fees
  - Debt or additional equity financing provided by the sponsor
  - Corporate opportunity
  - Multiple portfolio companies
Fiduciary Duties: Case Studies – **Sponsor Exposure**

  - PE Firm acquired more than 65% of the company.
  - Through an affiliate, PE Firm also entered into a financial/advisory agreement with the company whereby PE Firm was entitled to receive up to $800,000 in fees annually.
  - The company already had $100 million in senior debt outstanding, and to finance continued operating losses, the company borrowed money from a PE Firm affiliate and another lender.
  - Despite numerous asset sales and restructurings, the company and its subsidiaries ultimately filed for bankruptcy.
Fiduciary Duties: Case Studies (Cont’d)


The bankruptcy trustee filed suit against PE Firm and its appointed directors (collectively, the “PE Firm Defendants”) alleging:

− PE Firm used its power as a majority shareholder of the parent company to cause its representatives to serve on the company’s board of directors and executive committee.

− PE Firm Defendants engaged in self-dealing and breached their fiduciary duties of good faith and loyalty when they wrongfully prolonged the company’s existence so that PE Firm could profit at the expense of the company and its creditors.

− PE Firm breached its fiduciary duty to the company’s creditors when it restructured the company’s debt in order to prefer PE Firm over non-insider creditors.

− PE Firm engaged in corporate waste in accepting certain fees from the company.

− PE Firm engaged in a civil conspiracy when, acting through its director-representatives, it caused the company to obtain counsel who subsequently advised the company to engage in transactions that preferred PE Firm over the claims of the company’s other unsecured creditors. Similar allegations have been asserted against Apollo and TPG in chapter 11 cases of Caesar’s Entertainment Operating Company and affiliates.
Fiduciary Duties: Case Studies (Cont’d)


  The PE Firm Defendants moved to dismiss the trustee’s claims, but the court denied the motion to dismiss.

  Because the trustee alleged that the PE Firm Defendants stood on both sides of the transactions (to the detriment of unsecured creditors), the burden shifted to the PE Firm Defendants to prove the transactions were entirely fair.
Fiduciary Duties: Case Studies (Cont’d)


The bankruptcy court applied California law to a claim for breach of fiduciary duty by directors of a California corporation, but stated that California law is no different than Delaware law on these issues.

- Engaged in an extensive discussion of the fact that the fiduciary duties of directors do not change when the company becomes insolvent.
- The only thing that changes is the standing of creditors to pursue claims for breach of fiduciary duty on a derivative basis.

Process is key:

Courts will not “second guess” the decision of disinterested directors made with reasonable diligence in ascertaining the facts and believed to be in the corporation’s best interests (this is so even if the directors make a bad or “stupid” decision) but the process is critical. The Business Judgment Rule “presuppose[s] that judgment – reasonable diligence – has in fact been exercised” and “a director cannot close his eyes to what is going on about him in the conduct of the business of the corporation and have it said that he is exercising business judgment.” Burt v. Irvine Co., 237 Cal. App. 2d 828, 852-53, 47 Cal. Rptr. 392 (1965)
Fiduciary Duties: Case Studies (Cont’d)

• AWTR Liquidation Trust v. 2100 Grand LLC (In re AWTR Liquidation Inc.), 2016 WL 1128029 (Bankr. C.D. Cal. 2016) (cont’d)

β The Business Judgment Rule will not apply unless the board exercises good-faith judgment that the corporation’s information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations.

β The Business Judgment Rule does not immunize directors for abdication of their duties.

β Adequacy of the board’s deliberations must be documented concurrently to eliminate any risk of future litigation alleging that the board did not adopt an adequate process.

β The court went on to hold that an exculpatory provision can excuse directors from the duty of care, but not the duty of loyalty or good faith.
Fiduciary Duties: Case Studies (Cont’d)

• AWTR Liquidation Trust v. 2100 Grand LLC (In re AWTR Liquidation Inc.), 2016 WL 1128029 (Bankr. C.D. Cal. 2016) (cont’d)

β Transition of the duty of directors in the event of insolvency is clear, but not always easy to apply.

− Directors may not know whether the corporation is insolvent at any given time, so the duty cannot change upon insolvency.
− The duty is to avoid actions that “unduly risk” corporate assets.
− Directors should seek to maximize the value of the corporation going forward with blinders on as to who receives the benefit of that decision.
− Shareholders have an incentive to take greater risks in an insolvent entity because they have nothing to lose. Directors should not do so, but can take reasonable risks.
Fiduciary Duties: Takeaways for Sponsors

• Sponsor director-appointees must know and fulfill their duties.
• Directors should have protections from the company (e.g., indemnification provisions in operating documents, individual indemnification agreements, exculpatory clause, D&O insurance policy including side A coverage, definition of loss, and tail policies).
• Draft LLC agreements to maximize fiduciary duty waivers.
• Include waiver of corporate opportunities in certificate of incorporation.
  ß Establish record in support of corporation’s decision to decline specific opportunities.
• Ensure key negative controls are structured as a right of the equity holder of the portfolio company.
• Abstain from certain votes—if possible, an independent special committee should evaluate and approve potentially interested/conflicted transactions.
  ß Sponsor director-appointees should abstain where sponsor or its affiliates receive a benefit.
Fiduciary Duties: Takeaways for Sponsors (Cont’d)

• If a transaction must receive shareholder approval, any potentially interested/conflicted transaction should be approved by (1) an independent special committee and (2) a majority of the minority shareholders if possible.

See Kahn v. M & F Worldwide Corp., 88 A.3d 635 (Del. 2014) (merger between company and controlling shareholder reviewed under deferential “business judgment rule” standard where merger was conditioned on approval from independent committee and majority of minority shareholders).

• Consider having a senior representative, separate from the portfolio company’s board of directors, who is responsible for utilizing the sponsor’s shareholder veto rights.

This role allows the sponsor to demonstrate clear separation between the board’s decisions and the sponsor’s shareholder rights.
Criminal Risks

Joel M. Cohen
Gibson Dunn, White Collar Defense and Investigations Practice Group Co-Chair
Potential for Criminal Liability During Restructuring

• Prosecutors and investigators invariably follow the money in their pursuit of alleged fraud.
  § As market uncertainty deepens and corporate bankruptcy filings increase, bankruptcy could naturally become an area of focus for prosecutors seeking out potential targets for criminal prosecution.
• Additionally, disgruntled former employees, such as those who may be laid off or furloughed due to COVID-19, are more likely to report a financially distressed company to prosecutors.
  § Clients should enlist experienced counsel early to formulate a prompt and effective response if an investigation is initiated.
Bankruptcy Fraud Statutes

• Bankruptcy fraud is most commonly prosecuted under Sections 152 and 157 of Title 18 of the United States Code.
  § In nine subparts, Section 152 broadly criminalizes various actions prior to and during bankruptcy proceedings, including:
    – knowingly and fraudulently concealing assets,
    – making false statements, and
    – withholding information from the bankruptcy trustee.
  § Section 157 criminalizes utilization of bankruptcy proceedings to further a broader fraudulent scheme.
• Section 1519 imposes higher penalties—up to twenty years’ imprisonment—for the destruction, alteration, or falsification of records to interfere with a bankruptcy proceeding or investigation.
• Other sections criminalize embezzlement, agreements to fix fees or compensation, and knowing disregard of bankruptcy rules and procedures.
Penalties for Bankruptcy Fraud

- Judges, receivers, and trustees who reasonably believe a legal violation has occurred are required to report that violation to the U.S. Attorney’s office. 18 U.S. Code § 3057.

  - Section 2B1.1 of the United States Sentencing Guidelines is used to determine the base offense level for the majority of bankruptcy fraud crimes.
  - The base offense level is six for violations under Sections 152 and 157—where the maximum term of imprisonment is five years, but can be adjusted based on characteristics of the offense.
  - In cases of substantial financial loss or intended loss, the base level can be increased up to 30 levels, potentially resulting in a prison term of over 30 years.

- Victims are also entitled to receive full restitution based on their actual losses. 18 U.S. Code § 3663A.

Mandatory Reporting Requirement

- Judges, receivers, and trustees who reasonably believe a legal violation has occurred are required to report that violation to the U.S. Attorney’s office. 18 U.S. Code § 3057.
The U.S. Trustee Program

• The USTP—commonly referred to as the “watchdog” of the bankruptcy system—is a civil, litigating component of the U.S. Department of Justice, designed to protect “the integrity and efficiency of the bankruptcy system for the benefit of all stakeholders—debtors, creditors, and the public.”

• The USTP is headquartered in Washington, D.C. and has 92 field offices covering 21 regions.

• The USTP has a statutory duty to refer matters to the U.S. Attorney for prosecution, and has made over 2,000 such referrals annually since 2012.

• Members of the public can submit reports of suspected bankruptcy fraud to the U.S. Department of Justice and USTP.
Examples of Prosecutions

• In 2018, a husband and wife who had previously served as partners in a business venture were each sentenced to 50 and 27 months’ prison time, respectively, for tax evasion and bankruptcy fraud.

  § The couple filed for bankruptcy after attempting to settle over $600,000 in taxes due with the IRS, but simultaneously caused their companies to pay substantial amounts of personal expenses, including vacation home rental payments and a country club membership.

  § After a jury trial, the defendants were sentenced to jail time and ordered to pay $1.6 million in restitution to the IRS, and over $130,000 in a forfeiture money judgment.

Examples of Prosecutions (Cont’d)

• In May 2017, a former CEO of the electronics and appliance retailer Vann’s Inc. was convicted of 170 counts, including bankruptcy fraud, and sentenced to over five years in prison, including a $2.4 million criminal forfeiture verdict.

  The defendant, in conjunction with Vann’s former CFO, was accused of establishing two shell companies as part of a real estate leaseback scheme.

  The jury found the defendant had committed bankruptcy fraud by making a claim for $2.4 million against Vann’s estate on behalf of the shell companies after Vann’s declared bankruptcy in 2012.

Examples of Prosecutions (Cont’d)

• In 2016, the former President and CEO of PureChoice, Inc. was sentenced to 22 years in prison for 11 counts, including three for bankruptcy fraud, arising out of an investment fraud scheme.

  As the scheme unraveled and victims began demanding payment, the defendant filed for personal bankruptcy and was ultimately charged with bankruptcy fraud for falsifying statements and concealing property in connection with the bankruptcy proceeding.

  The defendant also was ordered to pay over $22 million in restitution and $7.6 million in a forfeiture judgment.


• Companies that engage with competitors regarding the purchase of assets from the bankruptcy estate could face liability under the Sherman Act.

• The bankruptcy trustee can also bring claims for civil liability against the purchaser under the Sherman Act during the bankruptcy court proceedings, in addition to claims under Section 363(n) of the Bankruptcy Code.

  Section 363(n) is akin to Section 1 of the Sherman Act, and permits avoidance of a sale “if the sale price was controlled by an agreement among potential bidders,” along with the recovery of the difference in the value of the property and the price paid, along with costs, fees, and punitive damages.

• The criminal penalties for a Sherman Act violation are severe—up to $100 million for a corporation and $1 million for an individual, along with up to 10 years in prison.
Closing Thoughts

Robert Klyman  
Gibson Dunn, Business Restructuring and Reorganization Practice Group Co-Chair

Joel M. Cohen  
Gibson Dunn, White Collar Defense and Investigations Practice Group Co-Chair
Appendices
Appendix I: Standards for Determining Solvency
Standards for Determining Solvency

• A solvency analysis is necessary to determine to whom directors’ duties are owed.

• There are two tests commonly employed:
  β the balance sheet test; and
  β the equity or cash flow test.

• Balance Sheet Test
  β A corporation is considered insolvent under the balance sheet test if the sum of its debts exceeds the aggregate value of its assets.

• Equity or Cash Flow Test
  β A corporation is considered insolvent under the equity or cash flow test if it is unable to pay its obligations as and when they come due. While there is no bright-line time frame established for this solvency test, courts typically look at foreseeable, near-term obligations.
Standards for Determining Solvency (Cont’d)

• Summary of Solvency Determination
  β As a practical matter, both solvency tests boil down to many of the same components.
  β To address the potential for judicial hindsight, a board should take a conservative approach to the valuation of its assets and liabilities, including contingent or off-balance sheet liabilities, and in its assessment of other liquidity or solvency issues.
  β In the event that a large contingent liability exists, such as a contested lawsuit, the company should value the contingent liability as the amount of the potential exposure multiplied by the probability of its future occurrence.
Deepening Insolvency Theory

- The theory of “deepening insolvency liability” for directors is not a cognizable cause of action in Delaware.

Deepening Insolvency is a theory of liability that provides that if a director causes a distressed company to take action or refrain from action that is not in the best interests of the company and which does not maximize the value of the company (and, in fact “deepens” the insolvency), the director may be liable for damages caused by such action or inaction.
Appendix II: Text of Relevant Bankruptcy Fraud Statutes
18 U.S.C. § 157 Bankruptcy Fraud

• A person who, having devised or intending to devise a scheme or artifice to defraud and for the purpose of executing or concealing such a scheme or artifice or attempting to do so—

  ß (1) files a petition under title 11, including a fraudulent involuntary petition under section 303 of such title;

  ß (2) files a document in a proceeding under title 11; or

  ß (3) makes a false or fraudulent representation, claim, or promise concerning or in relation to a proceeding under title 11, at any time before or after the filing of the petition, or in relation to a proceeding falsely asserted to be pending under such title, shall be fined under this title, imprisoned not more than 5 years, or both.
18 U.S.C. § 152 Concealment of assets; false oaths and claims; bribery

- A person who—
  
  β (1) knowingly and fraudulently conceals from a custodian, trustee, marshal, or other officer of the court charged with the control or custody of property, or, in connection with a case under title 11, from creditors or the United States Trustee, any property belonging to the estate of a debtor;
  
  β (2) knowingly and fraudulently makes a false oath or account in or in relation to any case under title 11;
  
  β (3) knowingly and fraudulently makes a false declaration, certificate, verification, or statement under penalty of perjury as permitted under section 1746 of title 28, in or in relation to any case under title 11;
  
  β (4) knowingly and fraudulently presents any false claim for proof against the estate of a debtor, or uses any such claim in any case under title 11, in a personal capacity or as or through an agent, proxy, or attorney;
  
  β (5) knowingly and fraudulently receives any material amount of property from a debtor after the filing of a case under title 11, with intent to defeat the provisions of title 11;
18 U.S.C. § 152 Concealment of assets; false oaths and claims; bribery (Cont’d)

β (6) knowingly and fraudulently gives, offers, receives, or attempts to obtain any money or property, remuneration, compensation, reward, advantage, or promise thereof for acting or forbearing to act in any case under title 11;

β (7) in a personal capacity or as an agent or officer of any person or corporation, in contemplation of a case under title 11 by or against the person or any other person or corporation, or with intent to defeat the provisions of title 11, knowingly and fraudulently transfers or conceals any of his property or the property of such other person or corporation;

β (8) after the filing of a case under title 11 or in contemplation thereof, knowingly and fraudulently conceals, destroys, mutilates, falsifies, or makes a false entry in any recorded information (including books, documents, records, and papers) relating to the property or financial affairs of a debtor; or

β (9) after the filing of a case under title 11, knowingly and fraudulently withholds from a custodian, trustee, marshal, or other officer of the court or a United States Trustee entitled to its possession, any recorded information (including books, documents, records, and papers) relating to the property or financial affairs of a debtor, shall be fined under this title, imprisoned not more than 5 years, or both.
18 U.S.C. § 153 Embezzlement against estate

• (a) Offense.—A person described in subsection (b) who knowingly and fraudulently appropriates to the person’s own use, embezzles, spends, or transfers any property or secretes or destroys any document belonging to the estate of a debtor shall be fined under this title, imprisoned not more than 5 years, or both.

• (b) Person to Whom Section Applies.—

A person described in this subsection is one who has access to property or documents belonging to an estate by virtue of the person’s participation in the administration of the estate as a trustee, custodian, marshal, attorney, or other officer of the court or as an agent, employee, or other person engaged by such an officer to perform a service with respect to the estate.
18 U.S.C. § 154 Adverse interest and conduct of officers

- A person who, being a custodian, trustee, marshal, or other officer of the court—
  1. knowingly purchases, directly or indirectly, any property of the estate of which the person is such an officer in a case under title 11;
  2. knowingly refuses to permit a reasonable opportunity for the inspection by parties in interest of the documents and accounts relating to the affairs of estates in the person’s charge by parties when directed by the court to do so; or
  3. knowingly refuses to permit a reasonable opportunity for the inspection by the United States Trustee of the documents and accounts relating to the affairs of an estate in the person’s charge, shall be fined under this title and shall forfeit the person’s office, which shall thereupon become vacant.
18 U.S.C. § 155 Fee agreements in cases under title 11 and receiverships

• Whoever, being a party in interest, whether as a debtor, creditor, receiver, trustee or representative of any of them, or attorney for any such party in interest, in any receivership or case under title 11 in any United States court or under its supervision, knowingly and fraudulently enters into any agreement, express or implied, with another such party in interest or attorney for another such party in interest, for the purpose of fixing the fees or other compensation to be paid to any party in interest or to any attorney for any party in interest for services rendered in connection therewith, from the assets of the estate, shall be fined under this title or imprisoned not more than one year, or both.
18 U.S.C. § 156(b) Knowing disregard of bankruptcy law or rule

- Offense.—If a bankruptcy case or related proceeding is dismissed because of a knowing attempt by a bankruptcy petition preparer in any manner to disregard the requirements of title 11, United States Code, or the Federal Rules of Bankruptcy Procedure, the bankruptcy petition preparer shall be fined under this title, imprisoned not more than 1 year, or both.
18 U.S.C. § 1519 Destruction, alteration, or falsification of records in Federal investigations and bankruptcy

• Whoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States or any case filed under title 11, or in relation to or contemplation of any such matter or case, shall be fined under this title, imprisoned not more than 20 years, or both.
Joel M. Cohen, a trial lawyer and former federal prosecutor, is Co-Chair of Gibson Dunn’s White Collar Defense and Investigations Group, and a member of its Securities Litigation, Class Actions and Antitrust Practice Groups. Mr. Cohen has been lead or co-lead counsel in 24 civil and criminal trials in federal and state courts. Mr. Cohen is equally comfortable leading confidential investigations, managing crises or advocating in court. Mr. Cohen’s experience includes all aspects of FCPA/anticorruption issues, insider trading, cross-border tax issues, securities and financial institution litigation, class actions, sanctions, money laundering and asset recovery, with a particular focus on international disputes and discovery.

Mr. Cohen was the prosecutor of Jordan Belfort and Stratton Oakmont, which is the focus of “The Wolf of Wall Street” film by Martin Scorsese. He was an advisor to the OECD in connection with the effort to prohibit corruption in international transactions and was the first Department of Justice legal liaison advisor to the French Ministry of Justice. Mr. Cohen is highly-rated in Chambers, where practitioners and clients have noted that he “is very, very good at getting the big picture . . . understanding where his clients want to be, which leads to better strategic judgments,” he has “incredibly strong substantive depth melded with a risk-based practicality,” “strong trial skills and handling of large-scale investigations,” is “very, very smart and very knowledgeable,” and praised his ability to “handle very intense, complex matters with regulatory authorities and really just deliver great results.” Mr. Cohen has been repeatedly named a leading white collar criminal defense attorney by The Best Lawyers in America®, a “Litigation Star” national Top 100 Trial Lawyer by Benchmark Litigation, an “MVP” by Law360, one of the world’s leading practitioners in White Collar Crime in Euromoney’s Expert Guides- White Collar Crime, a “Super Lawyer” in Criminal Litigation, and his work is noted by Legal 500 in the areas of white collar criminal defense and securities litigation. In addition, The American Lawyer named Mr. Cohen as one of its Litigators of the Week after winning a jury defense verdict in an insider trading case on behalf of Nelson Obus, general partner of Wynnefield Capital.

Mr. Cohen was featured in The American Lawyer’s 2016 award of “White Collar/Regulatory Law Firm of the Year” to Gibson Dunn for his Obus trial victory. Noting that his client was “in awe” of his trial and cross examination skills, The American Lawyer linked the trial victory with the SEC’s decision days after the defense verdict to avoid jury trials and seek administrative actions in the future.

Mr. Cohen received his bachelor’s degree from Middlebury College, his master’s degree in History from Duke University and his Juris Doctor from Duke University Law School, where he was a moot court champion. He is a member of the bars of New York and Massachusetts.
Robert Klyman

333 South Grand Avenue, Los Angeles, CA 90071-3197
Tel +1 213.229.7562
RKlyman@gibsondunn.com

Robert A. Klyman is a partner in the Los Angeles office of Gibson, Dunn & Crutcher and Co-Chair of Gibson Dunn's Business Restructuring and Reorganization Practice Group. Mr. Klyman represents companies, lenders, ad hoc groups of bondholders, acquirers and boards of directors in all phases of restructurings and workouts. His experience includes representing lenders and bondholders in complex workouts; advising debtors in connection with traditional, prepackaged and 'pre-negotiated' bankruptcies; counseling strategic and financial players who acquire debt or provide financing as a path to take control of companies in bankruptcy; structuring and implementing numerous asset sales through Section 363 of the Bankruptcy Code; and litigating complex bankruptcy and commercial matters arising in chapter 11 cases, both at trial and on appeal.

Turnarounds & Workouts named Robert Klyman to its 2016 list of Outstanding Restructuring Lawyers, honoring 12 attorneys as leaders in the bankruptcy field. In addition, Mr. Klyman has been widely and regularly recognized for both his debtor and creditor work as a leading bankruptcy and restructuring attorney by Chambers USA (where in 2019 clients recognized him as “great in court,” “a great strategist” and “incredibly technically sound”); named as one of the world’s leading Insolvency and Restructuring Lawyers by Euromoney; listed in the K&A Restructuring Register, a leading peer review listing, as one of the top 100 restructuring professionals in the United States; named as a 'Top Bankruptcy M &A Lawyer' by The Deal's Bankruptcy Insider; named as one of the 12 outstanding bankruptcy lawyers in the nation under the age of 40 (in 1999, 2000, 2002 and 2004) by Turnarounds & Workouts; and one of '20 lawyers under 40' to watch in California by the Daily Journal. Mr. Klyman also has been selected regularly by his peers for inclusion in The Best Lawyers in America© in the field of Bankruptcy and Creditor Debtor Rights.

Mr. Klyman developed, and for 20 years co-taught, a case study for the Harvard Business School on prepackaged bankruptcies and bankruptcy valuation issues. He has also taught classes on dealmaking in the bankruptcy courts at the University of Michigan Business School and UCLA Law School. Mr. Klyman is also a member of the ABA Subcommittee that drafted the recently released ABA Model Bankruptcy Asset Purchase Agreement.

Mr. Klyman received both his J.D. from the University of Michigan Law School in 1989 and his B.A. degree from the University of Michigan in 1986.
Emma Strong is an associate in the Palo Alto office of Gibson, Dunn & Crutcher. She practices with the firm’s Litigation Department. Ms. Strong has represented clients in internal investigations, government enforcement actions, and litigation involving civil fraud, breach of contract, trade secret, and patent infringement claims.

Ms. Strong graduated third in her class from UCLA School of Law in 2016, where she was elected to the Order of the Coif and served as Editor-in-Chief of the UCLA Women’s Law Journal. During law school, Ms. Strong served as a judicial extern for the Honorable Edward J. Davila of the Northern District of California and as a law clerk at Bay Area Legal Aid. She also worked as a research assistant for Professor Jon D. Michaels on topics related to national security and administrative law. Ms. Strong earned a Bachelor of Arts degree in Economics from Smith College in 2011.

Ms. Strong is admitted to practice in the State of California and United States District Courts for the Northern and Eastern Districts of California.
Professor Stuart Gilson is the Steven R. Fenster Professor of Business Administration at Harvard Business School, and former chairman of the Finance Unit. His research, teaching, and consulting focuses on the financial, business, and legal strategies that companies use to revitalize their business, improve performance, and create value when facing significant financial and operating challenges. He is an expert on corporate restructuring, valuation, business bankruptcy, credit analysis, and financial strategy.

Professor Gilson’s research has been published by leading academic and practitioner journals and has been cited by the national news media, including The Wall Street Journal, The New York Times, Business Week, The Economist, and Bloomberg. His work has received numerous honors, including the prestigious Graham and Dodd Award for his article on investment strategies used by hedge funds to acquire control of distressed companies. He has also written more than sixty HBS case studies that are used in business schools around the world. His best-selling book, Creating Value Through Corporate Restructuring: Case Studies in Bankruptcies, Buyouts, and Breakups (John-Wiley), is now in its second edition.

He is the recipient of the Charles M. Williams award in recognition of outstanding teaching in executive education at Harvard Business School. He currently teaches in the Advanced Management Program (AMP) and various other executive programs including YPO/WPO and Finance For Senior Executives. For twenty years he taught one of the most popular MBA courses at HBS, Creating Value Through Corporate Restructuring.

Professor Gilson consults for a variety of companies and organizations. He is a director of Advanced Alloy Processing LLC, and served on the advisory boards of the Turnaround Management Association and several investment funds. He provides expert testimony in corporate litigation, and is an academic affiliate of Cornerstone Research, a leading economic consulting firm. He also teaches Finance in custom executive training programs that he designs for individual client companies.
Allie Schwartz specializes in applying sophisticated financial and statistical analysis in civil and criminal litigations and regulatory investigations. She consults for clients and supports experts in matters related to the valuation of financial derivatives and securities, the assessment of the market structure of the underlying markets, and the trading behavior of participants in those markets. Dr. Schwartz has extensive experience with class certification and merits issues in securities class action litigation and in matters dealing with mortgages and related products. Her ongoing work includes antitrust matters in derivatives markets, microstructure and regulatory matters in the equities market, and benchmark manipulation cases.

Dr. Schwartz has worked on a variety of cases related to derivatives valuation; the assessment of transaction costs; and the evaluation of the structure of underlying markets, both over-the-counter markets and exchanges. Her work includes modeling cash flows, conducting risk analysis, and assessing potential losses due to allegations. She has experience across different types of products, among them equity options, commodities, structured products, credit and fixed income instruments, and mortgage-backed securities.

Dr. Schwartz has worked on numerous cases involving class certification and merits issues, including materiality, loss causation and assessment of damages. These matters have related to a variety of domestic securities: common stock, corporate bonds, mortgage-backed securities, and international ADRs, among others. Dr. Schwartz has worked on numerous notable securities class actions, including IBEW Local 90 Pension Fund et al. v. Deutsche Bank AG et al. and In re BP p.l.c. Securities Litigation.

Dr. Schwartz has addressed issues related to alleged anticompetitive behavior by rate-setting banks in major financial markets, and regulatory issues in trading equities and credit default swaps. She has analyzed trading strategies, materiality, and potential damages in insider trading cases. Dr. Schwartz has also assessed damages in cases involving alleged Ponzi schemes.

Dr. Schwartz has experience in numerous matters addressing loss causation, damages, and sampling in cases involving mortgage backed securities. She has modeled the drivers of mortgage performance and designed and reviewed sampling methodology. Dr. Schwartz has valued assets and financial instruments in matters involving bankruptcy and financial distress. She has addressed issues related to solvency and capital adequacy. Her research has been published in the Journal of Financial Economics. Prior to joining Cornerstone Research, Dr. Schwartz worked as an equity research analyst at Goldman Sachs & Co.